Jürgen Stark: The euro - the new European money

Speech by Dr Jürgen Stark, Deputy Governor of the Deutsche Bundesbank, at a conference hosted by the Deutsche Bundesbank in association with the Generalkonsulat and the German Information Center, New York, 19 November 2001.

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I am greatly honored to speak today before such a distinguished audience. It is good to be here in New York tonight – for I see this event also as a sign of solidarity and sympathy with a wonderful people and a great city. To us Germans, with the United States having stood by us for many decades following the Second World War, from the Berlin Airlift 1948/49 to reunification in 1990, solidarity should not and will not be – as Chancellor Gerhard Schröder put it a few days ago – a "one-way street". With our unconditional solidarity, we can now give back to you some of the support you have been giving us for so many years. I wish to express my heartfelt sympathy to all of those who lost relatives and loved ones in the horrible terror attacks of September 11. My sympathy also goes out to the families and friends of the victims of last week's plane crash in Queens. Even after these terrible few weeks, to me New York always has been and always will be a symbol of the peaceful coexistence of people from all backgrounds, one which is a shining example for the entire world.

I am therefore especially pleased to be here with you today. I am, of course, also glad that you have shown such great interest in this event and that it was possible to organize this event despite all the difficulties involved. My thanks go out to all those who made this happen. I hope that this event helps bring us a little closer to a state of normality.

I would like to talk to you this evening about "The euro – the new European money". When I spoke before the Council of Foreign Relations here 4½ years ago on the subject of European monetary union (EMU), I still needed to provide a lot of background. At that time, even a fairly sophisticated American dictionary offered only two definitions of EMU. The first said: "EMU = electromagnetic unit." The second said: "EMU: large Australian bird that runs well but cannot fly." Today there is hardly likely to be anyone who, upon hearing EMU, does not immediately think of European monetary union.

If you're thinking about coming to Europe next year, you will meet the euro wherever you go – because in just a few weeks it will exist in physical form. Paris, Rome, Brussels or Berlin: in most of Europe, you will be able to pay with a single currency – euro bills and coins – starting on January 1, 2002. For you here in the United States, it is natural that the dollar is legal tender in all fifty states of the Union. For us in Europe, though, monetary union is a quantum leap, both politically and economically.

In my speech I would like to address the following issues:

1. The historical background of the euro.
2. The essential features of the new system and its ramifications.
3. The future outlook for the euro – the political agenda.

The historical background of the euro

The euro is not quite as new as the title of my speech would lead you to believe. In fact, the euro is already a reality. The new European currency was born nearly three years ago when Europe entered Stage Three of economic and monetary union. However, compared with the dollar and its long tradition, the euro is a "rookie" in the monetary policy league. However, this "rookie" took the field after going through a tough "training camp" on the field of stability.

Nearly five decades ago, far-sighted European politicians kicked off the drive toward European unification. Sure, this drive has repeatedly been hampered by setbacks. However, the thrust towards greater integration has ultimately been unmistakable. European economic integration has been firmly established according to the principle of an "open market economy with free competition." This was not as obvious back then, as it seems today. Here in the United States, in particular, people might say "what else?" In Europe, though, it would behoove us to keep reminding ourselves of what it takes for a market economy such as ours to function properly. Only by paying attention to fundamental principles - personal responsibility, individual initiative, entrepreneurial spirit, and competition – can social equity

be achieved; and this is what is needed to overcome the severe structural problems that still beset Europe. We Europeans can learn much in this sphere from the United States.

The latest and greatest step towards integration in Europe has been entry into Stage Three of economic and monetary union. The euro-area countries have entered into a community of solidarity without any "exit." There is no precedent for this unique project. In fact, it can rightly be called the most significant innovation in monetary history since the creation of the Bretton Woods system in 1944.

This project is also unparalleled because clear preconditions needed to be met before EMU could be launched. The countries participating in monetary union needed to pass a stability test beforehand. Only then could their currencies merge to form the euro. By contrast, in the past currencies only ceased to exist after having failed to function as a store of value.

The historical, political and economic dimensions of this project are extraordinary. I sometimes get the impression that this is not being given its due on either side of the Atlantic – Europe or the United States. There still seem to be US investors who think that "EMU is crazy – in particular for Germany."

A single currency for Europe means waiving political sovereignty at the national level. This was a particularly difficult step to take for many people in Germany. That should come as no surprise: the D-Mark transcended its economic importance to symbolize the postwar reconstruction of Germany. The D-Mark stood for growing prosperity and Germany's reintegration into the international community. This success story also played a substantial role in the negotiations on EMU. Yet it was ultimately the courageous political will and the success in convergence achieved in the run-up which made it possible to turn the vision of "one market – one currency" into a reality. Through this well-prepared yet courageous step, Europe has received positive stimuli. The elimination of exchange-rate risk among the countries involved and the greater integration of financial markets are advantages that are immediately obvious. However, the medium-term orientation of monetary and fiscal policy represents an even greater success. A European stability culture has emerged! This signifies a paradigm shift in European economic policy.

The essential features of the new system and its ramifications

The new European reality, with a new economic policy regime, is a rather ambitious one. The path chosen was not the usual "one political entity - one currency" route but instead one in which a single monetary policy has to contend with budgetary and economic policies which are still largely in the hands of individual nations. This is a difficult concept to explain outside of Europe, even to those who have been keeping up with developments in Europe.

In the United States, there are some people who sometimes wonder how Europe really functions. By the way, we in Europe also wonder sometimes what makes the United States tick. We must learn to understand and accept existing institutional structures on both sides of the Atlantic. A chosen economic policy regime must be judged against the background of historical developments, traditions and its specific regional environment.

Naturally, the asymmetry between centralized monetary policymaking and decentralized economic and fiscal policy generates a certain tension. The way to overcome this state of tension is to closely coordinate decentralized economic and fiscal policy at the European level. Fiscal policy in the member states is additionally required by the Stability and Growth Pact to achieve the medium-term goal of a budget that is close to balance or even in surplus. One rationale for the Stability Pact was that it would be asking too much of a single monetary policy to be the sole defender of stability. The other was to keep government budgets sustainable. Public debt and the interest burden should not be allowed to go up after every economic slump as happened in the seventies and the early eighties. An additional factor is the unfavorable demographic trend in Europe. The aim is to regain fiscal policy room for maneuver and to avoid placing an undue burden on posterity.

This fiscal policy self-commitment in Europe is "revolutionary". Fiscal rules of this type are probably unprecedented worldwide. Yet these rules are not a straitjacket. In monetary union, the government sector has an important role in stabilizing demand. Through automatic stabilizers, the government budget has a steadying effect on economic development. In Europe, these automatic stabilizers are twice as effective as in the United States. One reason lies in the higher European general government ratio; another is the difference in the levels of social transfer payments. Given a 2 % decline in growth, these stabilizers restore ½ percentage point of GDP in the United States, whereas in Europe it would provide a fiscal stimulus of 1 % of GDP.

As you can see, it is expressly not the objective of the Stability and Growth Pact to stifle the ability of the budget to breathe in sync with the economic cycle. The Stability and Growth Pact is seen as a burden only by those member states which passed up the opportunity to consolidate their budgets over the past few years and which have so far failed to achieve a sustainable medium-term position. However, this sustainable medium-term budgetary position is a basic precondition for fiscal policy stimuli to be able to generate additional demand in the first place. Given unsound financing, in the private sector only the saving ratio would increase – to make up for impending tax increases or cutbacks in transfer payments. This is an aspect which I am afraid is all too often overlooked in the debate on European economic programs.

In addition, there are indeed serious reasons for objecting to an anti-cyclical fiscal policy. The time lags in the political decision-making process and in implementation are generally too great to preclude pro-cyclical effects. The fact that it will tend to have an adverse impact on interest rates should not be underestimated, either.

The situation from which fiscal policy starts out is a completely different argument. Here, the United States is in an entirely different position than Europe. In the euro area, the general government ratio is just under 49 % of GDP, and thus 1½ times that of the United States.

I intentionally placed fiscal rules in Europe at the top of my agenda for this talk. One reason is that this necessary implication of monetary union is often overlooked or not properly understood. The other is that fiscal rules are occasionally perceived as a barrier to greater economic growth in Europe. It is easier to get across the message that monetary union requires institutional changes in monetary policy.

Monetary union led to the creation of a new institution in Europe, the European Central Bank. It is an independent institution with the priority task of maintaining medium-term price stability. This approach is based on a broad consensus among central banks – not just in Europe but worldwide – that the best macroeconomic contribution monetary policy can make towards improving the economic outlook and raising standards of living is to credibly maintain price stability over the medium and long term. Within this consensus there are various concepts and different strategies that can also have a variety of ramifications.

At any rate, monetary policy cannot work wonders. Chairman Greenspan a week ago put it that way: Interest rate cuts are not an instant fix to every problem. However, it can contribute to low and stable inflation expectations. And stable money is a core element of the functional viability of a market economy. Transparency in price formation is improved by giving an undistorted view of supply and demand in the real economy. Keeping inflation as low as possible holds down long-term interest rates and minimizes the distorting effects of the tax and social welfare systems.

Decades of practical experience and a wealth of empirical studies have led in Europe to the mandating of price stability as a priority objective and have led to the transfer of this task to an Eurosystem, which is free of political influences. This mandate has been used to develop a stability-oriented monetary policy strategy tailored to the specific needs of the Eurosystem.

The changeover to a single monetary policy involved a pronounced regime shift. The structural and institutional changes and the resulting insecurity regarding the future transmission process needed to be taken into account when formulating the monetary policy strategy. For it to be able to perform its task, monetary policy needs to earn market participants' confidence. The monetary policy strategy must therefore be credible – while at the same time taking due account of the particular environment in which monetary union operates. Such a strategy must be clear, comprehensible, transparent, reviewable and compatible with the institutional independence of the Eurosystem.

The ECB's two-pillar strategy meets these criteria. The first pillar, which assigns an outstanding role to the monetary aggregate, is designed to be the "nominal anchor" and recognizes that inflation is essentially a monetary phenomenon. The second pillar undertakes a well-founded assessment of the outlook for price developments, incorporating the entire range of relevant cyclical indicators.

Many critics claim that this strategy is inconsistent. For that reason, some recommend strict monetary targeting, while others say inflation targeting is the way to go. I think the strategy chosen is sufficiently clear and reflects the specific situation the European monetary union now finds itself in.

In an insecure world, it is not possible to assign each of the two pillars a fixed and unchanging weight. Therefore, the information relevant to the price outlook is recompiled every time using the framework provided by the two pillars and subjected to a fundamental analysis. Yes, this concept is new and, for

that reason, takes some time getting used to. However, the euro was launched in a completely new environment, too. And this is why an independent approach was chosen. The assertion that the ECB's Governing Council bases its decisions arbitrarily on whichever pillar is most convenient at the time is completely unfounded. Today I would like to call on all of you to see this strategy as an independent approach alongside others and to accept it as such. Critics cannot use their own – wishful – thinking as a benchmark. And it should not be assumed that there is a global "one-size-fits-all" monetary policy.

Of course, this strategy being pursued by the Eurosystem requires a communication policy that meets high standards. Monetary policy cannot be successful in the long run if the public does not accept it. This is particularly the case with a young and independent central bank. It must constantly seek a dialogue with the public. What is often overlooked is that the ECB is one of the most transparent central banks in the world, with a communication policy that goes above and beyond its statutory obligations. Among the most important central banks, only the ECB holds monthly press conferences immediately after it has taken monetary policy decisions.

However, a "track record" says more than words can. Credibility is gained by actions, not words. For the Eurosystem, this means adhering to the primary objective of maintaining price stability "in a time-consistent" manner. The decisions of the past two months have clearly demonstrated the ability of the ECB to respond quickly to exceptional events without giving up its medium-term orientation. The ECB has taken due account of global developments and has assumed its share of responsibility for the stability of the international financial system. In my view, the ECB Governing Council's monetary policy decisions do not need to shy away from the critical attention of the public.

However, we should not make the mistake of attempting to transfer the macroeconomic framework as it exists in the United States to Europe or vice versa. On the one hand, long-term interest rates in Europe play a more important role in investment decisions. On the other hand, Europe is more heavily regulated and has less flexible labor markets. The European automatic stabilizers are more powerful. In the United States, wealth effects from the valuation of stock prices have a stronger influence on consumer behavior than in Europe.

In the seventies our attempts to implement short-term anti-cyclical economic policies taught us a tough lesson. The necessary adjustments came with a painfully high macroeconomic price tag. Even today many countries are suffering from the major debts run up in that period, which, in some cases, are over 100 % of GDP. The medium-term orientation of macroeconomic policies was hard-won. It is precisely in troubled times that this orientation should be adhered to.

The future outlook for the euro – the political agenda

Well now, what specific changes have taken place in Europe and what still has to be changed? Today's Europe does not resemble the sclerotic Europe of the eighties. Prior to monetary union, considerable adjustments were undertaken in the real economy, which are going to start having an impact over the medium term.

1. The economies of Europe have converged to form a single internal market. There are no more barriers to free trade in goods, services and capital. In the nineties, many countries' state-owned enterprises were privatized, and markets were liberalized and deregulated – particularly in the telecommunications, media and energy sectors. Monetary union is the final stage in achieving the single market. The money market is fully integrated, and the European capital market is also making great strides toward integration.

2. Monetary union means that exchange-rate adjustments are no longer possible in the euro area. The exchange-rate distortions that have occurred time and again due to external shocks, and the attendant expansion of interest-rate spreads, are now things of the past. These advantages were already evident in 1998 following the Russian and LTCM crises. These advantages have been equally evident in the past couple of months.

3. The euro-area fundamentals are quite strong. The results of the more medium-term policies, which have been implemented so far, have to be rated as positive. Since its inception, the ECB has largely guaranteed price stability. Interest rates are low and conditions for borrowing are favorable. Wage developments are moderate, and government budgetary consolidation is making progress.

However, there is no cause for complacency.

Economic growth in the euro area will be around 1½ % this year; for Germany this figure will be ¾ % at the most. At the same time unemployment, already high to begin with, will continue to rise - especially in the large economies. Europe's problem is that its potential growth rate is only a sluggish 2 to 2½ %. In the event of a global downturn, Europe will therefore quickly be pushed to the brink of economic stagnation.

The priority must therefore be to increase potential growth. This cannot be done over the long term by deficit spending, nor is an even easier monetary policy the answer. Economic reforms are the only road that will lead to success.

Despite the creditable steps toward reform that were taken in the nineties, European economies are still struggling under a raft of burdens from the past: high structural unemployment, a welfare state that is overstretching the capacity of many countries, and future strains caused by demographic developments. The euro and the current economic slump have made structural problems even more apparent. At the same time, the euro will prove to be the most ambitious reform program of the European Union. Any economy refusing to become more flexible will be left behind. Just a few days ago the IMF once again called on European governments to tackle structural problems on the labor market through, in its words, "a consistent and coherent set of labor market reforms." These problems "head the list of remaining structural priorities."

Especially in Germany, the issues involved are - among others -

- the degree of job security
- the type, amount and duration of unemployment benefits
- the wage formation process and wage differentiation
- the amount of non-wage labor costs and, by extension, social security reform.

These are all tasks that each country has to tackle and accomplish by itself. Monetary union requires flexibility at the national level – since exchange rates are no longer available as an adjustment parameter. Prior to EMU's inception, many critics pointed out that only an optimum currency area could afford to forgo flexible exchange rates as an adjustment tool in the event of asymmetrical shocks.

The mobility of labor as a factor of production in Europe, so the argument, is too restricted by cultural, linguistic and legal barriers to effect the necessary adjustment in a single currency area.

However, one of the most striking effects of the history of European integration has been that real shocks are becoming increasingly symmetrical. In addition, European economies are less regionally specialized in certain sectors of industry than, say, the United States. Therefore, the need for geographical mobility is likely to be a less important factor. Divergences exist in all currency areas, even in one as long established as the United States. In the euro area, inflation rates range at present from 1.6 % in France to 5.4 % in the Netherlands. By comparison, in the United States the inflation rate was 2.4 % in Chicago and 5.0 % in San Francisco. Divergences in real growth rates in the United States are no less pronounced than they are in the euro area, either. Forecasts for 2001 range from 6.3 % in Ireland to 0.7 % in Germany. In the United States, the average growth gap between the individual states in the nineties was as high as 7 % of gross state product (GSP).

Of course, much remains to be done. There is a clear correlation between the politically urgent structural reforms and the international standing of a currency. The development of the euro's exchange rate since 1999 has not been satisfactory, yet it is not a measure of the success or failure of EMU. The euro and globalization are exerting pressure on policies and markets in Europe to become more flexible. At the same time, however, the reforms will - in the medium to long term - accelerate the pace of economic growth and enhance the attractiveness of the euro area as well as the single currency. What will be a crucial factor, therefore, is that policymakers commit themselves in a credible manner to tackling the necessary changes and, at the same time, to safeguarding the stability of the euro. As monetary history has repeatedly shown, a stable internal value is the precondition for gaining that sustained confidence of international investors, which also gives a currency its external stability.

One of the main tasks of the national central banks of the Eurosystem at present is preparing for the cash changeover on January 1, 2002. This is a tremendous logistical task. It is a great challenge to all of us. But I am confident. We will have a smooth transition from national currencies to the euro. I am also convinced that the issuing of the euro in physical form will help to improve acceptance of the new currency in Europe and in particular in Germany. The results of the latest Eurobarometer opinion

survey show already a growth in support for the euro. In the euro area, 66 % of the people support the single currency. Germany is still lagging behind, with 53 % in favor of the euro; however, this is a significant improvement compared with the previous opinion survey.

From an economic point of view the changeover is a non-event; but it is not a merely technical process. It is the final and historical step towards further political integration in Europe. At least, I hope that the euro will also function as a catalyst in that direction. After all, history tells us that normally the territory of a political entity and the monetary area is identical. This is not - or nor yet - the case in Europe. As a consequence, monetary union cannot stand alone. In the medium term, EMU will need to be underpinned by political union. In particular, the stage of intergovernmental cooperation must be overcome in foreign and defense policies, and in domestic and legal policies. That means national interests have to become manageable and ultimately to be overcome in order to move on to truly common European policies.

The deepening of European integration and the enlargement of EU offer a unique opportunity to integrate Europe peacefully and to create a region of stability and prosperity. Slowly but surely Europe is beginning to liberate itself from political standstill. Political processes take time since they need to be supported by a public majority. The deepening of integration and the enlargement of the EU both need the support of suitable political and macroeconomic framework conditions. This includes in particular, favorable growth and employment trends, which, in turn, can only be brought about in an environment of price stability.

For the first time in history, Europeans from Lapland to Portugal and from Ireland to Greece will use the same currency. And what is also of importance: for the first time since the empire of Charlemagne 1,200 years ago, French and Germans will be united by a single currency.

I am convinced that the euro will become a symbol of identification with Europe and of the idea of deeper European integration – if the euro stays a stable currency. This symbol reflects a strong political will and a long-lasting process of economic and political integration:

- towards an open market economy,
- towards free competition,
- towards tolerance and democracy,
- towards freedom and peace.